PRUDENTIAL PRACTICE GUIDE

APG 120 Securitisation

January 2018
Disclaimer and Copyright

This prudential practice guide is not legal advice and users are encouraged to obtain professional advice about the application of any legislation or prudential standard relevant to their particular circumstances and to exercise their own skill and care in relation to any material contained in this guide.

APRA disclaims any liability for any loss or damage arising out of any use of this prudential practice guide.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0). This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit https://creativecommons.org/licenses/by/3.0/au/
About this guide

Prudential practice guides (PPGs) provide guidance on APRA’s view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA’s prudential standards, but do not themselves create enforceable requirements.

*Prudential Standard APS 120 Securitisation* (APS 120) sets out APRA’s requirements in relation to the involvement of authorised deposit-taking institutions (ADIs) in securitisation. This prudential practice guide aims to assist ADIs in complying with those requirements and, more generally, to outline prudent practices in relation to securitisation.

Subject to the requirements of APS 120, ADIs have the flexibility to configure their risk management framework for securitisation in the way most suited to achieving their business objectives.
## Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset-backed commercial paper (ABCP) securitisation</strong></td>
<td>A securitisation that predominantly issues commercial paper to investors with an original maturity of one year or less.</td>
</tr>
<tr>
<td><strong>APS 001</strong></td>
<td><em>Prudential Standard APS 001 Definitions</em></td>
</tr>
<tr>
<td><strong>APS 112</strong></td>
<td><em>Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk</em></td>
</tr>
<tr>
<td><strong>APS 113</strong></td>
<td><em>Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk</em></td>
</tr>
<tr>
<td><strong>Basis swap</strong></td>
<td>An interest rate swap aimed at limiting basis risk in a securitisation. A basis swap includes a payment stream on one leg of the swap based on an observable market rate or index, and a payment stream on the other leg based on rates set by a party to the swap, typically the originating ADI.</td>
</tr>
<tr>
<td><strong>Credit enhancement</strong></td>
<td>A contractual arrangement in which the ADI or other entity provides some degree of protection against credit losses to other parties holding a securitisation exposure.</td>
</tr>
<tr>
<td><strong>Early amortisation</strong></td>
<td>A mechanism in a securitisation of revolving credit facilities that, once triggered, accelerates the reduction of the investor’s interest in the underlying exposures and allows investors to be paid out, in full or in part, prior to the originally stated maturity of the securities issued.</td>
</tr>
<tr>
<td><strong>ECAI</strong></td>
<td>External credit assessment institution</td>
</tr>
<tr>
<td><strong>Implicit support</strong></td>
<td>Support provided by an ADI to a securitisation in excess of its explicit contractual obligations.</td>
</tr>
<tr>
<td><strong>Managing ADI</strong></td>
<td>An ADI that manages a securitisation. This may include undertaking responsibility for the day-to-day administration of the securitisation special purpose vehicle, allocation of collections, calculation of payments and preparation of investor reports. A managing ADI may also manage swaps, liquidity and other facilities and events such as the issuance, rollover/refinancing or calling of securities.</td>
</tr>
<tr>
<td><strong>Non-senior exposure</strong></td>
<td>A securitisation exposure that is subordinated to senior securitisation exposures.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Originating ADI</td>
<td>With respect to a securitisation, an ADI that directly or indirectly originates underlying exposures in the pool; is the managing ADI for the securitisation; or provides a facility (other than a derivatives transaction) or credit enhancement to an ABCP securitisation.</td>
</tr>
<tr>
<td>Pool</td>
<td>The underlying exposure or exposures that are securitised by way of assignment or the transfer of rights and obligations to, or by way of rights and obligations held directly in its name by, an SPV. The pool may consist of, but need not be limited to, loans, bonds or equities.</td>
</tr>
<tr>
<td>Resecuritisation exposure</td>
<td>A securitisation exposure in which at least one of the underlying exposures in the pool is a securitisation exposure. An exposure to one or more resecuritisation exposures is a resecuritisation exposure. An exposure resulting from retranching of a securitisation exposure is not a resecuritisation exposure if the ADI is able to demonstrate that the cash flows to and from the ADI replicate in all circumstances and conditions an exposure to a securitisation of a pool of assets that contains no securitisation exposures.</td>
</tr>
<tr>
<td>Securitisation</td>
<td>A financing structure where the cash flow from a pool is used to make payments on obligations to at least two tranches or classes of creditors (typically holders of debt securities), with each tranche or class entitled to receive payments from the pool before or after another class of creditors, thereby reflecting different levels of credit risk.</td>
</tr>
<tr>
<td>Securitisation exposure</td>
<td>On-balance sheet and off-balance sheet risk positions held by an ADI arising from a securitisation including, but not limited to, investments in securities issued by an SPV, credit enhancements, liquidity and other funding facilities and derivatives transactions.</td>
</tr>
<tr>
<td>Securitisation of revolving credit facilities</td>
<td>A securitisation in which one or more underlying exposures represent, directly or indirectly, current or future draws on a revolving credit facility.</td>
</tr>
<tr>
<td>Self-securitisation</td>
<td>A securitisation which is solely for the purpose of using the securities created as collateral in order to obtain funding via a repurchase agreement with the Reserve Bank of Australia (RBA).</td>
</tr>
<tr>
<td>Seller interest</td>
<td>A senior or <em>pari passu</em> interest to a senior interest held by an originating ADI of a securitisation of revolving credit facilities that is collateralised by the revolving pool of underlying exposures, equivalent in size to the total asset pool less the investor interest.</td>
</tr>
<tr>
<td><strong>Senior securitisation exposure</strong></td>
<td>A securitisation exposure effectively backed or secured by a first claim on the entire amount of the assets in the underlying pool. Securitisation exposures with different maturities that share pro rata loss allocation with senior securitisation exposures so that they benefit from the same level of credit enhancement are themselves senior securitisation exposures.</td>
</tr>
<tr>
<td><strong>SPV</strong></td>
<td>A special purpose vehicle that purchases and holds, or otherwise holds directly in its name, the pool for the purpose of a securitisation. The SPV’s acquisition of exposures held in the pool is typically funded by debt issued by the SPV, including through the issue of securities or units by the SPV.</td>
</tr>
<tr>
<td><strong>Synthetic securitisation</strong></td>
<td>A securitisation whereby the credit risk, or part of the credit risk, of a pool is transferred to a third party which need not be an SPV. The transfer of credit risk can be undertaken through the use of funded (e.g. credit linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees.</td>
</tr>
</tbody>
</table>
Chapter 1 — Scope and definitions

Scope

1. APS 120 applies to an ADI on both a Level 1 and Level 2 basis. In determining significant credit risk transfer, an originating ADI (or a member of the group to which the originating ADI belongs) must not fund the acquisition of credit risk i.e. funding must be provided by third parties.

2. However, it is not APRA’s intent for APS 120 to apply, in determining significant credit risk transfer, to a member of a group outside of the Level 2 group e.g. statutory funds of life insurance companies, responsible entities, trustees or custodians acting on behalf of beneficiaries or members.

3. Under paragraph 2(d) of Attachment B to APS 001, a securitisation SPV is excluded from the Level 2 group where the originating ADI meets the operational requirements for regulatory capital relief (including significant credit risk transfer) for the securitisation. If the originating ADI does not meet the operational requirements for regulatory capital relief, it must treat the securitisation SPV as on-balance sheet for regulatory capital purposes.

4. Restrictions in APS 120 such as those applying to an originating ADI purchasing securities issued in a securitisation and purchasing exposures out of a pool (see Chapter 6 – Other issues) or holding a material beneficial interest in a securitisation SPV or trustee are also not intended to apply to non-consolidated subsidiaries (e.g. life insurance companies) acting on behalf of beneficiaries if such activity occurs in the normal course of business and is in accordance with the entity’s investment mandates and strategies.

5. If an originating ADI actively seeks to use a non-consolidated entity to circumvent the requirements of APS 120, APRA may consider such activity to constitute the provision of implicit support (see Chapter 4 – Implicit support and other risks). Similarly, APRA will not take a favourable view of originating ADIs entering into bilateral or multilateral arrangements to purchase the non-senior securities of other ADI-originated securitisations (see Chapter 6 - Other issues).

Definitions

Securitisation

6. The definition of securitisation requires multiple tranches of credit risk in a structure. If an SPV into which an ADI has originated assets does not meet this requirement, it falls under the calculation of regulatory capital for credit risk under APS 112 or APS 113, as appropriate. In terms of APS 112 or APS 113, if an ADI is required to consolidate the SPV under accounting standards, the exposures must be included within the Level 1 and Level 2 regulatory capital calculation.
7. APRA may determine that APS 120 applies to a particular arrangement as if it were a securitisation if APRA considers that it has features similar to a securitisation and gives rise to similar prudential risks. In considering whether a conduit structure is a securitisation, APRA intends that an ADI will look at the economic substance of the whole structure, rather than focus on the status of each SPV in the structure on a stand-alone basis. Where, when considered in its entirety, a conduit structure is a securitisation, APRA intends each SPV within the structure (including funding SPVs that do not meet the multiple tranche test in their own right) be treated as a securitisation. Where a conduit structure is an ABCP securitisation, an ADI that originates exposures (including an ADI that provides a liquidity facility or credit enhancement) into any SPV within the structure will need to treat the securitisation as an ABCP securitisation.

8. APRA expects ADIs to consult when there is uncertainty about whether a given transaction is considered a securitisation. For example, transactions involving cash flows from real estate (e.g. rents) may be considered specialised lending exposures, if warranted.

Resecuritisation exposure

9. APRA would generally consider a claim on a conduit structure that is a securitisation to be a resecuritisation exposure. APRA expects an ADI to treat a claim on a pool that is permitted to invest excess cash in authorised investments which can include securitisation exposures as a resecuritisation exposure.

Senior securitisation exposure

10. The definition of a senior securitisation exposure permits time tranching but not credit tranching of senior exposures. For example:

- in a traditional securitisation where all tranches above the first-loss piece are rated, the most highly rated position would be treated as a senior tranche. When there are several tranches that share the same rating, only the most senior tranche in the cash flow waterfall would be treated as senior [unless the only difference between them is maturity]. Also, when the different ratings of several senior tranches only result from a difference in maturity, all of these tranches would be treated as a senior tranche; and

- in a synthetic securitisation, an unrated tranche would be treated as a senior tranche, provided that all of the conditions for inferring a rating from a lower tranche that meets the definition of a senior tranche are fulfilled.
Chapter 2 — Separation and disclosure

Separation

11. APRA’s view is that a securitisation is more than a funding mechanism; it is an arrangement where the underlying pool of exposures is transferred to an SPV, with the intention that the underlying exposures will not return to the originating ADI other than in limited circumstances.

12. APRA envisages that the SPV, consistent with being the owner of the assets, would normally exercise all rights and obligations with respect to the assets on its own behalf without undue regard for the interests of the originating ADI. Also, as the independent owner of the assets, the SPV’s ongoing operations and fortunes would not be expected to be tied to those of the originating ADI and it would have an ability to distance itself from the originating ADI.

13. Separation between an ADI and an SPV would normally be reflected in the following features:

   - the SPV could continue to exist and operate as the owner of the pool of assets even if the ADI withdraws [subject to meeting its contractual obligations] from providing facilities or services;
   - a default or a ratings downgrade of the ADI would not of itself constitute an event of default on the SPV’s securities; and
   - the financial position of the SPV does not depend on the financial standing or rating of the ADI.

14. APRA does not expect an SPV, in the ordinary course, to have its own staff or operational infrastructure. An SPV might outsource its operations, subject to normal arm’s-length outsourcing arrangements, to the originating ADI or another party. However, the SPV would usually need to have a governance structure and access to sufficient staff, data, operational infrastructure and systems, amongst other factors, to enable it to continue operating if, for whatever reason, an originating ADI is not able to provide a facility or service. Such situations could include where the ADI:

   - decides to withdraw from or wind down all or part of its securitisation activities;
   - decides to exercise a right to terminate facility or service agreements;
   - is subject to a credit rating downgrade;
   - goes into administration or liquidation; or
   - seeks to sell a subsidiary that provides services.
15. A key principle of APS 120 is that an ADI must deal with an SPV and its investors on an arm’s-length basis and on market terms and conditions. APRA views this as a two-pronged test under which an ADI would generally be able to demonstrate that:

- its dealings with an SPV (and the SPV’s investors) are on the same contractual basis as it would ordinarily use for dealings with an independent ‘third-party’ SPV (and the SPV’s investors); and
- the terms and conditions are broadly equivalent to those under which an independent third party would offer to transact.

**Disclosure**

16. APS 120 requires an originating ADI to ensure clear and prominent disclosures of certain matters in documents inviting investment in a securitisation. Good practice would be to include the disclosures as a stand-alone item on the inside front cover of the document.

**Exposures transferred in a securitisation**

17. An ADI is required to obtain a written opinion from legal counsel that the exposures transferred in a securitisation are beyond the reach of the ADI and its creditors, including in the case of the appointment of a statutory manager (or its equivalent), or its winding up and receivership. Where loans are equitably assigned, but are subject to a title perfection event, APRA expects that this legal opinion will cover the situation where the appointment of an ADI statutory manager occurs before title can be perfected. In addition, this opinion would be expected to also canvass the impact of the appointment of a statutory manager on any cash collateral and similar arrangement related to the securitisation which gives rise to an asset on the ADI’s balance sheet.

**Legal opinion**

18. APS 120 provides APRA discretion to require an ADI to seek a legal opinion on any of requirements relating to separation and disclosure, exposures transferred in a securitisation and any other requirement of APS 120. APRA does not expect to use these powers routinely. Instances where it might be considered appropriate to require a review include where there are concerns with the quality of the opinion provided in a self-assessment undertaken by the ADI, where unique or novel legal issues are raised by a particular transaction or structure, or where, through its supervisory activities, APRA has concerns that the requirements may not be met in practice.
Chapter 3 — General capital adequacy requirement

Capital relief securitisation

19. If an originating ADI seeks regulatory capital relief for a securitisation, it may structure the securitisation by having sub-classes of non-senior securities and over time sell these securities to third parties to achieve capital relief. This means significant risk transfer may not occur when the securities are issued – taking longer would only have the effect of delaying any capital benefit. In this instance the originating ADI would continue to hold regulatory capital for the underlying exposures in the pool until all the operational requirements for regulatory relief are met.

Funding-only securitisation

20. APRA’s objective is to achieve clarity and simplicity in a funding-only structure. In general, a single tranche of non-senior securities supports this objective. Furthermore, time or credit tranching is not generally needed as the originating ADI would generally hold all the non-senior securities in a funding-only securitisation. However, an originating ADI may time or credit tranche non-senior securities in a funding-only securitisation, provided the securitisation is not structured with a date-based call option. This is to facilitate a transition to a capital relief securitisation should the ADI achieve significant credit risk transfer at some point in the life of the securitisation.

Operational requirements for the use of external credit assessments

21. APS 120 requires an ADI to apply the external credit assessments of an external credit assessment institution [ECAI] consistently across a given type of securitisation exposure.

22. APRA is aware situations have arisen, in certain structures, where one ECAI has rated a number of tranches of notes (or other exposures) and another ECAI has rated fewer tranches (and has either not been asked to or has chosen not to rate the other tranches or exposures). This is against the intention of APS 120 that there be no ‘cherry picking’ involved in the use of ECAs and that ECAs are used by the SPV on a consistent basis. In these situations, APRA would expect the ADI to presume that the exposures not rated by the second ECAI have effectively been assigned a rating of unrated and so the ADI must assign capital to those exposures actually rated only by one ECAI as if they were unrated.
Information on the underlying collateral supporting securitisation exposures

23. APS 120 requires an ADI to deduct a securitisation exposure from regulatory capital where it does not perform an adequate level of due diligence. As part of this due diligence, an ADI must be able to access detailed performance information on the underlying pools on an ongoing basis in a timely manner. APRA expects that such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and measures of industry and geographic diversification.

24. APRA would expect that a similar level of detail is available for each of the pools that underlie the securitisation exposures which result in an exposure being considered a resecuritisation.

25. It would be prudent practice for an ADI to ensure that the information it has access to on an ongoing basis is collected, reviewed and assessed on a regular basis in a timely manner. APRA expects that the ADI would put in place policies establishing the review cycle for all types of securitisation exposures, which includes triggers for more intensive or more regular reviews of exposures.

26. APS 120 requires an ADI to have a thorough understanding of all structural features of a securitisation transaction that would materially affect the performance of the ADI’s exposures to the transaction. These structural features would ordinarily include the contractual waterfall and waterfall-related triggers, credit enhancements, swaps, call options, liquidity enhancements, market value triggers, and deal-specific definitions of default.

Spread accounts and similar surplus income arrangements

27. APS 120 sets out the requirements for spread accounts and similar arrangements. In assessing whether an arrangement meets these requirements, APRA envisages that an ADI would look at the economic substance of the arrangement rather than only the legal form.

28. Other arrangements that might fall under these provisions could include residual capital units and bonus fees for servicing. The latter depends on the normal or base fee being set on a full market rate basis and the base or underlying agreement meeting all of the relevant requirements of APS 120 in its own right.

29. In general, APS 120 prohibits the originating ADI from increasing a retained first loss position or credit enhancement. This is not intended to capture a structural arrangement set at the inception of a securitisation, such as a surplus income arrangement, that is available to cover losses in the scheme. In this situation, the ADI does not provide funding to increase the position, and it cannot recognise for regulatory reporting purposes any income that may arise from its entitlement until it is irrevocably
earned. However, if the formula for retaining amounts in the securitisation is changed after inception of the arrangement, APRA will consider such a change as a form of credit enhancement.

**Unfunded support**

30. The requirements in paragraph 56 of APS 120 apply to situations where an ADI holds a securitisation exposure which receives a lower capital requirement by virtue of unfunded credit support provided by the ADI itself acting in a different capacity in the securitisation transaction. APRA envisages that an ADI would take into account the economic substance of that support in the context of the overall transaction and any circumstances in which the ADI could become exposed to a higher credit risk in the absence of that support.

31. When the risk of missing payments arises from temporary factors e.g. timing mismatches, it may be considered a form of liquidity risk rather than credit risk.

**Liquidity facilities**

32. There are two broad types of liquidity facilities used in the Australian market: those that provide short-term funding to cover timing mismatches between the receipt of payments from the underlying pool and the payments due to note holders (see section on ‘Unfunded support’); and those for ABCP securitisation. The latter are standby facilities that provide funding to the SPV should it be unable to refinance or rollover maturing short term paper in the market (and so operate as structural borrowings). The former facility will be sized as a relatively small proportion of the pool, while the latter will often virtually cover the whole pool. Regardless of type, liquidity facilities must not be capable of being drawn for the purpose of credit support.

33. An originating ADI of an ABCP securitisation must treat the securitisation as funding-only. This means that an ADI that provides a liquidity facility to an ABCP securitisation is also captured as an originating ADI and must include the underlying assets in its calculation of credit risk-weighted assets under APS 112 and APS 113, as appropriate.

34. APRA envisages that there would be no securities that are being funded where a liquidity facility provided to a non-ABCP securitisation only covers timing mismatches. In these circumstances, APRA would expect that the draws are neither significant in size in relation to the pool nor structural (providing medium to long-term funding) in nature. APRA would not expect drawings under a timing mismatch liquidity facility to remain outstanding after a period of three months.

35. APRA considers structural borrowings to be in the nature of funding rather than timing mismatch liquidity facilities. In particular, APRA believes it may be difficult, given their cash flow characteristics, to structure a liquidity facility to a reverse mortgage securitisation to meet the requirements of Attachment D of APS 120.
Other funding facilities

36. APS 120 requires that the repayment of draws on liquidity and other funding facilities provided by an ADI must never be subordinated to any interest of any investor. Where an originating ADI is providing a funding facility to a scheme e.g. a redraw funding facility (that is not being assessed as a securitisation of revolving credit facilities under APS 120), APRA would also expect a relatively low limit to be in place and the limit to reduce in amount as the pool reduces. In determining the appropriateness of any limit, an originating ADI would take into account factors such as:

- the nature of the facility;
- the intended use;
- the amount of redraw that borrowers have available;
- the intended run off/resizing over the life of the pool; and
- the normal level of similar facilities in other ADIs’ securitisation schemes.

37. Some managers and administrators of securitisation vehicles fund redraws on the assets. These generally balance on a monthly basis and only trigger drawdowns on the redraw funding facility at the end of period. In these situations the ADI will advance the redraws during the month. Interest free loans are therefore being made by the ADI to the SPV intra-month. In such cases, the ADI will need to consider the requirements of APS 120 to ensure that appropriate capital is held against any undrawn commitments to its customers whose facilities have been transferred to the SPV.

38. In terms of measuring the undrawn portion of a servicer cash advance, APRA does not intend to set a fixed proportion. However, APRA would expect that a servicer cash advance would be limited and sized as a relatively small proportion of the pool.

Treatment of warehouse and similar structures

39. Warehouse arrangements typically accumulate assets until a sufficiently large pool is available for issuance of securities in a term securitisation. An ADI originating exposures into a warehouse SPV needs to carefully consider the implications, should the warehouse SPV not rollover to a term securitisation before the notional expiry of the warehouse funding line. In particular, the ADI runs the risk that the warehouse funder may perfect its title in the pool and sell the exposures to a third party who may seek to service the exposures.

40. A warehouse arrangement may qualify for regulatory capital relief if an originating ADI meets the criteria in Attachment A of APS 120. This criteria includes significant credit risk transfer and permanency of funding.

41. In meeting the permanency of funding criteria, an originating ADI may agree to a new funding rate to extend a warehouse funding line, as long as the funding rate reflects the
then-current market pricing and no other terms and conditions of the securitisation are amended.

42. If an originating ADI and warehouse provider cannot agree to extend a warehouse funding line, a predetermined step-up margin may apply, as long as it is not funded by the originating ADI. Where the warehouse funding line has not been extended, the structure would need to be automatically placed into amortisation with assets funded to the contractual maturity date of the exposures in the pool.

43. Before entering into a basis swap arrangement, APRA would expect an originating ADI to take into account any contingences (such as changes in funding rates or changes in funding composition) in considering whether it would be likely to require the ADI to become a net payer if these contingencies were triggered (see section on ‘Basis swaps’).

**Securitisation of revolving credit facilities**

44. In a securitisation of revolving credit facilities, APS 120 requires any scheduled or early amortisation and similar provision to end the ability of the originating ADI to add new exposures to the pool. For revolving exposures (e.g. credit cards), there is generally a requirement to continue to fund new drawings on credit cards, subject to the ADI’s right to cancel these cards with notice. For revolving exposures, new drawings on credit cards, after an amortisation event, must be funded outside the securitisation pool. A small percentage of line of credit mortgage loans would not typically render an entire transaction as a securitisation of revolving credit facilities. However, a residential mortgage master trust structure that involves a seller interest and includes scheduled or early amortisation and similar provisions would typically be treated under the provisions in APS 120 relating to securitisation of revolving credit facilities.

45. An originating ADI must not increase a retained first loss position or provide additional credit enhancement, even in a funding-only securitisation. Where it relates to the same pool of assets, the required level of subordination of a new series must be proportionately the same as that of an existing series under the securitisation.

**Basis swaps**

46. In a securitisation, the basis on which the underlying assets are priced generally differs from the basis on which payments are made to investors. Basis swaps provide a mechanism to transform the nature of the cash flows from the underlying assets to meet the needs of investors in a securitisation.

47. APRA recognises that many basis swaps are inherently non-arm’s length. However, APRA’s approach is that basis swaps must be structured such that the ADI is not a net payer over the life of a securitisation. This relates to the principle of separation – APRA expects that an ADI would not be contributing to the ongoing funding costs of the securitisation vehicle. This does not mean the ADI must demonstrate that it will never be a payer, only that it is not a net payer over the life of the securitisation.
48. A securitisation may be structured with one or more bullet securities. Hard bullets, which must be paid in full on maturity, must not be funded by the originating ADI. In the case of funding-only securitisation only, an originating ADI may fund a soft bullet by exercising a date-based call option. APRA would expect an ADI could demonstrate that any step-up margin payable on the securities in the event a call option is not exercised would not result in the originating ADI becoming a net payer over the life of the transaction under any basis swap provided by the ADI to the securitisation.

49. In constructing a basis swap, APRA expects an originating ADI would, before entering into the swap, take into account any step-up margin payable on the securities in considering whether it would be likely to require it to become a net payer if that contingency was triggered.

50. Basis swaps also need to be assessed in the context of an ADI’s asset-liability and interest rate risk management policies, including consideration of the need to hedge these exposures.

**Synthetic securitisation**

51. Credit risk of a loan or reference portfolio may be transferred from a protection buyer to a protection seller via credit risk mitigation [e.g. credit default swaps or guarantees]. These transactions are captured as synthetic securitisations if tranched risk is created as a result of the credit risk mitigation.

52. Where an ADI is a protection buyer, APS 120 does not recognise synthetic securitisation for regulatory capital relief. An ADI that is a protection seller in a synthetic securitisation would need to apply APS 120 to determine the appropriate regulatory capital for its securitisation exposure i.e. tranched cover.

53. APS 120 does not recognise, for regulatory capital purposes, the use of credit risk mitigation on a resecuritisation exposure or an exposure required to be deducted or a non-senior securitisation exposure.

**Self-securitisation**

54. APS 120 clarifies that an ADI that undertakes a self-securitisation must comply with the prudential standard from the point it uses the securities as collateral to obtain funding under a repurchase agreement with the RBA. Up until the point these securities are used as collateral under the repurchase agreement with the RBA, the self-securitisation does not exist for the purposes of APS 120.

55. To avoid any conflict between an ADI meeting the provisions required under APS 120 and the eligibility requirements set by the RBA for use of securitised assets in repurchase agreements, APS 120 provides some exemptions for self-securitisation only. These exemptions apply to self-securitisation to afford ADIs flexibility to satisfy a security’s eligibility for purchase by the RBA under the repurchase agreement. APS 120 also recognises that the originating ADI may give an undertaking to ‘repurchase’ the securities under the repurchase agreement with the RBA.
Cash collateral

56. Cash collateral provided to a back-up swap or other service or facility provider where the cash collateral is not in the name of the SPV may not be assessed as an overlapping securitisation exposure to any swap provided to the securitisation vehicle. Where an ADI provides cash collateral to a back-up swap provider, it needs to assess the exposure against the requirements of APS 112 to calculate the appropriate risk weight.

Shared collateral and trust-back agreements

57. Some ADIs have trust-back agreements in place that enable them to maintain a security interest for non-securitised loans (e.g. a personal loan, a home equity line of credit) where the underlying collateral (e.g. a residential property loan) has been assigned to a securitisation SPV. These agreements do not provide for the ADI to rank pro rata or better in respect of proceeds from realising security and do not involve a formal second mortgage from the borrower.

58. Consistent with APS 112, only where an ADI has a formal second mortgage in place can the underlying collateral be recognised for risk weighting purposes. ADIs may choose to operate trust-back agreements to address any administrative and logistical issues. For the purposes of paragraph 67 of APS 120 only, an ADI may recognise trust-back agreements for risk weighting purposes as equivalent to formal second mortgages provided:

- that the rights and protections afforded to the ADI under a trust-back agreement provide equivalent rights and protections to those which the ADI would have as the holder of a formal second mortgage; and

- the ADI obtains a written legal confirmation that the rights and protections afforded to the ADI under a trust-back agreement are equivalent to a formal second mortgage, including the ADI’s unequivocal right to access the shared collateral in the event of default of the non-securitised loan and following the occurrence of a title perfection event.

59. An ADI that enters into trust-back agreements would assign risk weights to the non-securitised loans on the basis of its subordinated position in regard to the securitised loans. As detailed in APS 112, in order to determine the risk weight for non-securitised loans, the loan-to-valuation ratio for the non-securitised loan would be based on the sum of all claims on the borrower secured by both the first and second mortgages (or its equivalent) over the same collateral. In calculating the risk weight for the non-securitised loan under APS 113, an ADI would need to take into account its subordinated position in regard to the collateral and the borrower’s total indebtedness secured by the shared collateral in determining the appropriate probability of default and loss given default estimates.
Chapter 4 — Implicit support and other risks

Implicit support

60. APS 120 requires that an ADI must not provide, or knowingly allow the perception to arise that it will provide, support to a securitisation in excess of the ADI’s explicit contractual obligations. To do so would be to provide implicit support. In addition, the Board of directors and senior management must put policies and procedures in place that outline how the ADI will ensure it is not providing implicit support for a securitisation.

61. APRA’s intent is that each ADI be responsible for ensuring that its transactions are not structured and, equally importantly, its ongoing operations are not carried out, in a way that gives the impression that the ADI supports the securitisation over and above any explicit contractual requirements.

62. APRA envisages that ADIs will develop risk management policies and procedures for their ongoing securitisation activities (see Chapter 5 – Risk management framework). These would be designed to provide assurance that an ADI is complying with its contractual obligations and, where it seeks to depart from these, to ensure that there is an appropriate review procedure in place to ensure that the departure could not be seen as giving rise to implicit support (or to otherwise breach the requirements of APS 120).

63. Examples of situations that might be seen as providing implicit support include:

- an originating ADI refinancing or restructuring lower quality loans in a pool so that they are eligible to be repurchased by the ADI;
- an originating ADI making an indemnity or other payment or accepting a lower fee or reduced charge in lieu of passing on a full increase in a required or threshold rate;
- an originating ADI purchasing the assets held in an SPV to allow the SPV to avoid making a formal draw on a liquidity facility;
- an ADI actively seeking to refinance loans it originated into an SPV where the required or threshold rate arrangement is above its normal lending rate for similar non-securitised loans or materially above the general market rate for such loans;
- an ADI entering into a facility to purchase assets from an SPV at above market rates (e.g. via a liquid asset purchase agreement or a market value agreement);
- an ADI purchasing assets held in an SPV or securities issued by an SPV at above market rates;
• an ADI providing funding to a party to enable it to exercise a call option that the ADI is not permitted itself to exercise directly;

• an ADI exercising a call option that acts as a credit enhancement;

• an ADI providing facilities or services or purchasing securities or repurchasing exposures via non-consolidated subsidiaries, outside the scope of their normal activities, that the ADI (or its Level 2 entities) would not be permitted to provide or purchase directly; or

• an ADI changing the terms for determining the amount distributed to the income and/or other unitholders after establishment of a securitisation (e.g. increasing the amount retained within the securitisation as a liquidity pool).

64. Examples of situations that might be seen as providing implicit support to a securitisation that requires rollover or refinancing (e.g. warehouse arrangements) also include the ADI:

• providing new or additional representations and warranties in respect of the pool (or refreshing representations and warranties in such a manner that means the ADI is responsible for changes in the pool composition or quality since the exposures were originally transferred into it);

• taking action to rebalance the pool e.g. repurchasing loans that the alternative funder does not wish to acquire;

• providing additional credit enhancements or support to the pool that increase the ADI’s first loss position;

• providing any additional finance to the pool; or

• reducing the cost of facilities, derivatives transactions and services provided to the SPV (unless it can clearly be shown to reflect changes in market rates).

65. If APRA assesses that an ADI has provided implicit support to a securitisation vehicle, it may impose capital penalties commensurate with the risk of the provision of support. Each situation will be assessed individually with the circumstances, motivations and means of discovery of the support, amongst other factors, to be taken into consideration when deciding APRA’s response.

Quantitative and qualitative limits on securitisation activity

66. APS 120 provides that, in certain circumstances, APRA may impose quantitative or qualitative limits on an ADI’s securitisation activities. Such restrictions could include:

• prohibiting an ADI from undertaking further securitisation activity until the Board of directors and senior management of the ADI can establish they have an appropriate understanding of the ADI’s securitisation structures, activities and exposures;
• prohibiting an ADI from undertaking specific securitisation activity until the ADI can establish that it has the capacity to undertake a detailed and effective self-assessment of its activity;

• prohibiting the ADI from undertaking further activity until the ADI has developed adequate policies and procedures to govern its securitisation activity;

• imposing a limit on the value of an ADI’s securitised loan book (e.g. based on its balance sheet) where it is considered to rely excessively on securitisation to fund its lending operations; and

• prohibiting an ADI from seeking to wind-up, or accelerate the wind up, of a securitisation structure, in a manner inconsistent with APS 120.

Prior notification

67. The prior notification requirements in APS 120 are not intended for non-complying securitisation, i.e. an originating ADI must comply with the funding-only or capital relief requirements in regard to securitisation.

68. Where prior notification is required for other secured funding arrangements, an ADI will need to establish to APRA’s satisfaction that the proposed arrangement does not undermine the depositor protection provisions of the Banking Act 1959.
Chapter 5 — Risk management framework

69. APS 120 requires an ADI to put in place policies and procedures related to securitisation. These policies would be expected to cover all aspects of APS 120 relevant to the ADI, including the due diligence process and the identification of capital requirements. This includes credit risk, concentration risk, market risk, liquidity risk, legal risk and reputational risk.

70. To help mitigate these risks, APRA envisages that an ADI’s securitisation activities (both on- and off-balance sheet) would be expected to be included in all of the ADI’s risk management disciplines such as product approval, risk concentration limits and estimates of market, credit and operational risk.

71. APRA expects that all risks arising from securitisation would be addressed in an ADI’s Internal Capital Adequacy Assessment Process (ICAAP). These risks include:

- credit, market, liquidity and reputational risk of each exposure;
- potential delinquencies and losses on the securitisation exposures and the underlying securitised exposures;
- exposures from credit lines or liquidity facilities to SPVs;
- exposures from derivatives transactions to SPVs; and
- exposures from guarantees and insurance provided by monolines (lenders mortgage insurers and credit wrap providers) and other third parties.

72. It is prudent practice for an ADI’s securitisation exposures to be captured in the ADI’s information and accounting systems to help ensure that senior management understands the implications of such exposures for liquidity, earnings, risk concentrations and capital. An ADI would be expected to have the necessary processes in place to capture, in a timely manner, information on securitisation transactions including market data, if available, and updated performance data from the securitisation trustee or service provider.

73. APRA expects an ADI to analyse the underlying risks when investing in a structured product and not solely rely on external credit assessments. Where external assessments are utilised as an aid in the credit approval process, it would be prudent for an ADI to fully understand and be comfortable with the methodology applied by the external assessor. While external ratings are a useful starting point for credit analysis, they are not a substitute for a full and proper understanding of the underlying risk, especially where ratings for an asset class have a short history or have been shown to be volatile.

74. APRA expects an ADI to conduct credit analysis of a securitisation exposure before acquisition of the exposure and on an ongoing basis. APRA envisages an ADI would have in place the necessary quantitative tools, valuation models and stress tests of sufficient sophistication to reliably assess all relevant risks. An ADI would be expected
to fully understand the credit quality and risk characteristics of the underlying exposures in structured credit transactions, including any risk concentrations. In addition, in order to assess potential maturity mismatches, it would be prudent practice for an ADI to review the maturity of the exposures underlying structured credit exposures relative to the issued liabilities.

75. APRA envisages an ADI would produce reliable measures of aggregate risk and track all meaningful concentrations in securitisation exposures, such as name, product or sector concentrations. This information would be expected to feed into firm-wide risk aggregation systems that track exposures (e.g. credit) to a particular counterparty.

76. It is considered prudent that an ADI’s own assessment of risk be based on a comprehensive understanding of the structure of the securitisation transaction. APRA expects that an ADI would identify the various types of triggers (including scheduled and early amortisation and similar provisions), call options, credit events and other legal provisions that may affect the performance of its on- and off-balance sheet exposures, and integrate these triggers and provisions into its funding/liquidity, credit and balance sheet management. APRA envisages that an ADI would also consider the impact of the events or triggers on its liquidity and capital position.

77. It is considered prudent practice that an ADI consider scenarios which may prevent it from securitising assets as part of its stress testing and identify the potential effect of such exposures on its liquidity, earnings and capital adequacy.

78. APRA expects an ADI to have prudent contingency plans, specifying how it would respond to funding, capital and other pressures that arise when access to securitisation markets is reduced. The contingency plans would be expected to also consider how the ADI would address valuation challenges for potentially illiquid positions held by it. The risk measures, stress testing results and contingency plans would be expected to be incorporated into the ADI’s risk management processes and its ICAAP.

79. An ADI that employs risk mitigation techniques would be expected to fully understand the risks to be mitigated, the potential effect of that mitigation and whether or not the mitigation is fully effective.

Self-assessment

80. APS 120 requires an ADI to undertake a written assessment for each securitisation in which it participates, demonstrating compliance with the requirements of the prudential standard. This applies to all securitisation transactions with an SPV, even when the ADI is merely a facility provider (e.g. a swap provider) to a securitisation scheme or undertakes a securitisation for funding-only purposes. An ADI may decide the most appropriate format for the assessment. An assessment that considers each relevant requirement under APS 120 individually and clearly sets out references to supporting transaction documentation, policies and procedures, opinions and assessments will assist APRA’s understanding of the ADI’s compliance process. APRA would expect that the assessment will be maintained on an ongoing basis, will have regard to any changes in the prudential standard or market practice, and will be signed
off by senior staff from the ADI’s securitisation and legal, compliance or risk management areas.

81. While APRA will obtain regular reporting on securitisation transactions under the ADI reporting framework, APRA will generally not review the assessments as they are made or in advance of issuance. However, a review may be undertaken in specific situations (e.g. if there are prudential concerns with an ADI’s self-assessment practices or capacity to undertake self-assessments).

82. Where an ADI is seeking to enter a securitisation transaction which contains features the ADI has not previously encountered, it may wish to discuss the treatment of the securitisation exposure with APRA. APRA will, however, expect the ADI to forward its assessment of the issue and to highlight the specific area of uncertainty, and APRA will rely on the information provided in forming its assessment. The ADI will need to ensure that all relevant details are provided, as APRA reserves the right to reconsider the position should any additional relevant details subsequently come to light.

83. APRA envisages that its supervisors will request copies of a sample of self-assessments and the underlying transaction and disclosure documentation when conducting prudential reviews of ADIs. For originating ADIs, this will generally be in the context of a credit risk review. However, where an institution has a book of market-rate related transactions with SPVs, significant holdings of SPV securities, significant liquidity lines to securitisation schemes or call options, such a review may well occur in the context of a market risk or liquidity management review.

84. APS 120 requires the ADI’s involvement with a securitisation to be set out in legal documentation, including legally enforceable contracts and investor documentation. APRA’s expectation is that the key requirements relating to the securitisation will be set out in writing and that this written detail will form the basis of the documentation used in the self-assessment. APRA does not believe it is appropriate to rely upon verbal assurances, operational understandings or other undocumented information when an ADI assesses whether it will be in compliance with the requirements of APS 120.

85. APS 120 requires an ADI to consider the economic substance rather than only the legal form in calculating the appropriate regulatory capital requirement for a securitisation exposure. APRA expects that each assessment will describe the capital methodology used for the exposures related to that transaction. APRA would not see it as appropriate for an ADI to take a mechanistic legal approach to assessing compliance; rather, staff with a detailed understanding of each specific transaction and its position within the broader securitisation structure would normally be involved.
Chapter 6 — Other issues

Purchase of securities issued in a securitisation

86. An originating ADI must not repurchase its own non-senior securities once sold, except to give effect to a call option where permitted under APS 120.

87. An originating ADI is generally free to purchase its own senior securities; however any purchase must not otherwise provide implicit support to a securitisation. Implicit support could be evident where, for example, senior securities are purchased to repay investors that would not otherwise be permitted under APS 120 (e.g. where the purchase of securities is above market prices or is to give effect to a call option which is not otherwise permitted under APS 120).

88. Outside routine market making whereby senior securities are usually resold within a short period or where senior securities are acquired to give effect to a date-based call option in a funding-only securitisation, APRA would expect that an originating ADI would not hold a disproportionate share of its own senior securities. As a guide, an originating ADI would not normally hold more than 20 per cent of the value of senior securities outstanding throughout the life of the scheme. In a securitisation of revolving credit facilities, the guide of 20 per cent would only relate to an ADI’s [senior] investor securities rather than its seller interest [the ADI’s seller interest does not include the ADI’s [subordinated] investor securities].

89. An originating ADI will need to monitor its share of its own senior securities.

90. In its self-assessment, an originating ADI is expected to outline the policies and procedures in place to:
   - monitor its own holdings of securities; and
   - ensure that it takes timely action to reduce its own holdings of securities where appropriate.

Repurchase of exposures out of a pool in a securitisation

91. APS 120 places restrictions on the ability of an originating ADI to enter into a call option. APRA does not intend this restriction to extend to call options entered into by another entity [outside the ADI’s Level 2 group], provided the originating ADI does not facilitate that entity’s funding of the exercise of the call option. Similarly, APRA does not intend to prevent the call option being entered into by a non-consolidated subsidiary of the originating ADI (e.g. a life insurer) on behalf of its beneficiaries, in the normal course of business and consistent with its investment mandates and strategies.
92. APRA expects that an ADI would not create a market expectation that it will exercise a call option or include in any contractual terms features that might give rise to such an expectation.

93. APS 120 permits an originating ADI to repurchase exposures from an SPV if the repurchase is to grant a further advance to the borrower or similar purpose. This need may arise if the ADI remains the lender of record and retains the customer relationship and so has the legal obligation to the customer. The intent is that this provision facilitates an ADI’s ability to respond to customer-initiated transactions that may make the loan ineligible under the SPV’s criteria to remain in the pool.

94. Examples of situations that could be seen as similar purposes include:
   - a change in the interest rate basis of the loan (e.g. moving from a floating rate to a fixed rate);
   - a change in the interest rate structure of a loan (e.g. from an amortising loan to an interest-only loan);
   - a change in the loan structure (e.g. moving from a full documentation to a low documentation loan); and
   - a change in or substitution of the mortgage security.

95. While it is considered appropriate to accommodate these sorts of arrangements, the provisions should not be used to transfer doubtful or lower quality exposures in the pool back to the originating ADI or to accelerate the winding down of the pool (which would likely amount to implicit support).

96. In particular, APRA would not expect an originating ADI to make a general offer to refinance (prior to scheduled maturity) its customers’ loans held in a pool. Rather, APRA would expect customers to initiate the transactions in the normal course of meeting their banking requirements.

97. APRA would generally not expect an ADI to exercise a call option when this would result in it acquiring assets of an SPV which were offered for sale to a third party (including another SPV) and the third party declined to acquire them. For example, where a third party holds a call option over the pool (or part thereof) and exercises it, then APRA would not expect the ADI to subsequently exercise its call option to acquire any assets that remain in the SPV after the exercise of this option. Prima facie such an arrangement is seen as being structured to avoid allocating losses to credit enhancements or positions held by investors (by facilitating the accelerated wind up of the SPV).

Facilities and services

98. APS 120 states that a facility or service agreement does not need to specify a fixed termination date provided the ADI has the right, at its absolute discretion, to withdraw from its commitments at any time following a reasonable period of notice.
99. This reinforces the notion of the separation of the SPV (see Chapter 2 – Separation and disclosure) and is designed to ensure an ADI has the capacity to promptly and effectively distance itself from an SPV should it choose to do so. While APS 120 does not set a fixed time limit, APRA has typically considered 90 days to be a reasonable maximum period of notice.

100. To be consistent with the notion of separation, APRA does not consider that a requirement for withdrawal from a facility or service to be dependent on the appointment of an alternative provider. Similarly, the need for an ADI to post collateral for, or the right for an SPV to draw on, a facility in the event of the ADI’s withdrawal from a facility would not generally be considered to be consistent with absolute discretion. This reflects the fact that, in substance, the ADI retains the economic risk of providing the facility, which is inconsistent with the intention that the risk lapses or ceases at the end of the notice period (other than where a facility has already been drawn in accordance with its terms and conditions and repayment is still outstanding).

101. APS 120 requires that, in specified circumstances and subject to reasonable qualifications, the SPV and/or investors must have the express right to select an alternative party to provide the facility or service.

102. APRA would expect the SPV to have an ability to cease its relationship with the ADI, if the SPV considered it necessary to do so. APRA would also expect that the SPV would not be unduly restrained in the choice of an alternative facility or service provider.

103. APRA expects an ADI to undertake its own assessment of the reasonableness of the restrictions that apply to the SPV’s ability to seek an alternative facility and service provider. It is expected that an ADI would compare the restrictions both to other securitisation schemes [particularly those involving other ADIs] and also to its non-securitisation dealings. For example, an ADI might compare the restrictions on the SPV seeking an alternative [non-basis swap] derivative provider and the consequences [e.g. break fees] of doing so with the terms in derivatives deals with non-securitisation SPVs and also corporate counterparties.

104. Examples of terms that might not be considered reasonable qualifications include:

- a requirement that the SPV must not appoint a competitor to the ADI to provide the facility or service; and

- a requirement that replacement can only occur if a fraud has been perpetrated.

105. Where it is not feasible for an independent third party to quote a rate for conducting the transaction [e.g. a basis swap], it would be difficult, in APRA’s view, to establish that the deal is on an arm’s-length basis and on market terms and conditions.

106. APS 120 requires that an ADI’s derivatives transactions with an SPV must not bear a subordinated position to any investor in the securitisation scheme or be subject to deferral or waiver. This ranking of derivatives does not include where the ADI is a defaulting party under a swap, and for uncollected break fees (including break fees that have not been collected from the underlying borrower).
Representations and warranties

107. APS 120 deals with compensation for a breach of any representation or warranty given by an ADI to an SPV. Aside from the circumstances covered in APS 120, APRA intends that an ADI retain full discretion as to how it should rectify a breach of a representation or warranty. In particular, it must not have any obligation to, and there must be no expectation that it will, automatically repurchase exposures to rectify a breach.

108. Where a breach is identified, APRA expects that an ADI would identify the remedial action necessary to prevent future breaches of a similar nature. APRA expects the ADI to decide the most appropriate manner to rectify the breach, whether that be the payment of damages (which must not exceed a reasonable estimate of the loss suffered by the SPV) or the reassumption of credit risk of the exposure. In the latter case, APRA’s expectation is that this will generally be done in a manner that leaves the exposure within the SPV (e.g. via a guarantee). Consistent with the separation of the ADI and SPV, an outright repurchase would be viewed as a last resort in those cases where no other option is considered practical or effective.

109. Where an ADI is required to notify APRA about the payment of damages or the reassumption of credit risk, APRA expects this notice would include an outline of:

- the circumstances behind the breach;
- the response to the breach;
- what alternatives were considered [e.g. damages versus reassumption of risk, how damages were quantified, why reassumption of the risk was agreed and how the particular manner of reassuming risk was chosen];
- who ultimately approved the action taken; and
- the rectification action being taken to prevent further breaches.
Annexure — Regulatory capital calculation

Illustrative examples of the regulatory capital calculation using the External Ratings-based Approach and Supervisory Formula Approach

**External Ratings-based Approach**

**Example capital structure**

<table>
<thead>
<tr>
<th>Class</th>
<th>External rating (long term)</th>
<th>Amount ($m)</th>
<th>Credit support (%)</th>
<th>Maturity (years)</th>
<th>Risk weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (senior)</td>
<td>AAA</td>
<td>460</td>
<td>8.0</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>AB (non-senior)</td>
<td>AA</td>
<td>30</td>
<td>2.0</td>
<td>5</td>
<td>112.8 or 120</td>
</tr>
<tr>
<td>B (non-senior)</td>
<td>Unrated</td>
<td>10</td>
<td>0</td>
<td>5</td>
<td>Common Equity Tier 1 (CET1) capital deduction</td>
</tr>
</tbody>
</table>

For the risk weight calculation, refer to Attachment C of APS 120.

In this example, assume the unrated B (non-senior) tranche is deducted.

An ADI would assign a risk weight for the AAA rated A (senior) tranche of 20 per cent.

An ADI has two options to assign a risk weight for the AA rated AB (non-senior) tranche:

- An ADI may take into account tranche maturity and tranche thickness in calculating the risk weight. The resultant risk weight, taking into account tranche maturity and tranche thickness, is 112.8 per cent i.e. \[1.20 \times [1 - \min(0.08, 0.02; 50\%)] = 1.128;\] or

- An ADI may assign a risk weight of 120 per cent.
Supervisory Formula Approach

Example capital structure

<table>
<thead>
<tr>
<th>Class</th>
<th>Amount ($m)</th>
<th>Credit support (%)</th>
<th>Attachment point (A) (%)</th>
<th>Detachment point (D) (%)</th>
<th>Maturity (years)</th>
<th>Risk weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (senior)</td>
<td>460</td>
<td>8.0</td>
<td>8.0</td>
<td>100.0</td>
<td>5</td>
<td>15.0</td>
</tr>
<tr>
<td>AB (non-senior)</td>
<td>30</td>
<td>2.0</td>
<td>2.0</td>
<td>8.0</td>
<td>5</td>
<td>785.9</td>
</tr>
<tr>
<td>B (non-senior)</td>
<td>10</td>
<td>0</td>
<td>-</td>
<td>2.0</td>
<td>5</td>
<td>CET1 capital deduction</td>
</tr>
</tbody>
</table>

For the risk weight calculation, refer to Attachment C of APS 120.

In this example, assume the pool of underlying exposures is comprised of standard residential mortgages so that $K_{SA} = 0.028$ (i.e. 0.35 x 0.08). In addition, assume the ratio of delinquent underlying exposures to total underlying exposures in the pool ($W$) is 0.01 and the ADI is aware of the delinquency status of the underlying exposures.

Thus,

$$K_a = ([1 - 0.01] \times 0.028) + [0.01 \times 0.5] = 0.03272$$

$$a = -1/([1 \times 0.03272]) = -30.56234719$$

$$u = 1 - 0.03272 = 0.96728$$

$e$ is the base of the natural logarithm, 2.718281828...

For the A (senior) tranche:

$$l = \max(0.08 - 0.03272), 0) = 0.04728$$

Therefore,

$$K_{SA}(K_a) = (e^{-30.56234719 \times 0.96728} - e^{-30.56234719 \times 0.04728}) / -30.56234719 \times (0.96728 - 0.04728) = 0.008384463$$

$A > K_a$, i.e. $0.08 > 0.03272$, so the risk weight of the tranche, expressed as a percentage, equals $K_{SA}(K_a) \times 12.5$ i.e. $0.008384463 \times 12.5 = 0.104805787$
The 15 per cent risk weight floor applies to the A (senior) tranche given the resultant risk weight of 10.48 per cent.

For the AB (non-senior) tranche:

\[ l = \max(0.02 - 0.03272, 0) = 0 \]

Therefore,

\[ K_{SSFA}(K_A) = 0.529 \]

\[ A < K_A \text{ i.e. } 0.02 < 0.03272 \text{ and } D > K_A \text{ i.e. } 0.08 > 0.03272, \text{ so the risk weight of the tranche is 785.964 per cent.} \]

For the B (non-senior) tranche:

\[ D < K_A \text{ i.e. } 0.02 < 0.03272 \text{ so the exposure must be deducted.} \]